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Supreme Court of the United States

OCTOBER TERM, 1979

No. 79-1721

CARLE FOUNDATION, AN ILLINOIS NOT FOR PROFIT CORPORATION,

Petitioner,

vs.

UNITED STATES OF AMERICA,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT.

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Petitioner,

vs.

UNITED STATES OF AMERICA,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT.

The Petitioner, Carle Foundation, specifically prays that a writ of certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Seventh Circuit entered in this proceeding, as modified, on February 1, 1980.

OPINIONS BELOW

The opinion of the Court of Appeals [611 F. 2d 1192], appears in the Appendix hereto. [A1-A13].* Because the Court's

* Parenthetical page references preceded by the letter "A" refer to the pages of the printed Appendix hereto.

opinion was based on an outdated Treasury Regulation and a case which relied on such regulation, the opinion was subsequently modified in an order on rehearing. Such order appears in the Appendix hereto. [A14-A17] The findings and opinion of the District Court for the Eastern District of Illinois, Danville Division, which have not been officially reported, also appear in the Appendix. [A18-A27]

JURISDICTION

The judgment of the Court of Appeals for the Seventh Circuit was entered on November 29, 1979. A timely petition for rehearing was filed. On February 1, 1980 the Court of Appeals entered certain modifications to its November 29, 1979 opinion and simultaneously denied the petition for rehearing. This petition is being timely filed. This Court's jurisdiction is invoked under 28 U. S. C. § 1254(1).

QUESTION PRESENTED

Whether a tax exempt hospital's performance of a health care support service, the sale of pharmaceuticals, to a non-exempt clinic providing primary ambulatory health care as an integral part of such hospital's delivery of health care and to the outpatients receiving such ambulatory care, constitutes an unrelated trade or business and is therefore taxable under 26 U. S. C. §§ 511-513.

STATEMENT OF THE CASE

This action arose out of the Petitioner's seeking of a refund of federal income tax in the amounts of $35,949.13 and $20,166.34 for the fiscal years ended June 30, 1971 and June 30, 1972, respectively, erroneously assessed and collected by the Internal Revenue Service.

At issue is whether sales of pharmaceuticals by the Petitioner, a tax-exempt hospital, to a for-profit outpatient clinic organized separately from the Petitioner but operated as an integral part of the Petitioner's medical complex and sales directly to outpatients for use off the premises of the Petitioner's medical complex are taxable as an unrelated trade or business under 26 U. S. C. §§ 511-513.

The government contends that such sales are unrelated to the Petitioner's exempt purposes and are therefore taxable. It is the Petitioner's position that such sales are substantially related to its exempt purposes and are not taxable because they are an integral and essential part of the health care services which it provides directly through its hospital and indirectly through agreements with the separately organized clinic. The District Court, after hearing substantial testimony, agreed with the Petitioner's position. The Court of Appeals for the Seventh Circuit reversed and held for the government.

The Petitioner seeks the granting of certiorari by this Court based on the following:

1. The issue of liability for unrelated business income taxes arising from a hospital's performance of an integral health care function on behalf of patients being treated under a hospital sponsored ambulatory health care delivery system is an important question of first impression under 26 U. S. C. §§ 511-513. The Court of Appeals' decision,

if allowed to stand, will have a serious adverse effect on the ability of tax-exempt hospitals to reduce health care costs and to innovate in their delivery of health care so as to continue to provide better health care.

2. The Court of Appeals' adoption of "unfair competition" as the primary criterion for determining whether an activity constitutes an unrelated trade or business is an important question for substantially all tax-exempt organizations. This criterion will automatically result in the taxation of previously untaxed activities of such organizations and also raise serious questions with respect to the continued tax-exempt status of many of such organizations.

3. The Court of Appeals' decision interpreting 26 U. S. C. § 513 conflicts with the decisions of numerous other lower courts.

The law applicable in this case is set forth in 26 U. S. C. §§ 511 through 513. Section 511(a)(1) imposes a tax on the "unrelated business taxable income" of most tax exempt organizations. Section 512(a)(1) defines the term "unrelated business taxable income" as meaning:

> [T]he gross income derived by any organization from any unrelated trade or business (as defined in section 513) regularly carried on by it . . .

26 U. S. C. § 512(a)(1). Section 513(a) provides that the term "unrelated trade or business" means:

> [I]n the case of any organization subject to the tax imposed by section 511, any trade or business the conduct of which is not substantially related . . . to the exercise or performance by such organization of its charitable, educational or other purpose or function constituting the basis for its exemption under section 501 . . .

26 U. S. C. § 513(a). Treas. Reg. § 1.513-1(d)(2) explains the substantially related test in more detail as follows:

> Trade or business is 'related' to exempt purposes, in the relevant sense, only where the conduct of the business activities has causal relationship to the achievement of exempt purposes (other than through the production of income); and it is "substantially related," for purposes of section 513, only if the causal relationship is a substantial one. Thus, for the conduct of trade or business from which a particular amount of gross income is derived to be substantially related to purposes for which exemption is granted, the production or distribution of the goods or the performance of the services from which the gross income is derived must contribute importantly to the accomplishment of those purposes.

Treas. Reg. § 1.513-1(d)(2) (1975).

The Petitioner is a not-for-profit hospital exempt from federal income taxes under 26 U. S. C. § 501(c)(3). In furtherance of its exempt purposes, the Petitioner owns a medical complex which provides inpatient and outpatient health care services to the general public. [A2]

The Petitioner has structured a health care delivery system which provides an extremely broad range of health care services encompassing primary, secondary and tertiary care on an inpatient and outpatient basis. These health care services are provided through two legally distinct but medically integrated and legally related health care providers—the Petitioner and the Carle Clinic Association ("Clinic"). The Petitioner owns and directly operates the hospital portion of the medical complex. The Clinic is an unincorporated association of hospital based physicians engaged in the group practice of medicine for profit. Inpatient and some forms of outpatient care are provided in the Petitioner's hospital by the physicians of the Clinic in their role as the medical staff of the hospital. Primary health care on an outpatient basis is provided through the physicians in the Clinic. [A2]

The Petitioner and the Clinic through various agreements have integrated and coordinated their roles in providing health

care. For example, with exception of a small courtesy staff the medical staff of the Petitioner's hospital consists only of Clinic physicians of which there were approximately one hundred. [A2] The health care provided in the Petitioner's hospital and in the Clinic is monitored on an overall basis by the same committee of physicians. The progress of an individual patient as he moves through the health care continuum provided by the Petitioner, including treatment in both the hospital and the Clinic, is monitored by numerous joint committees of the Clinic and the hospital. [A20] A single medical record is maintained for all patients in the medical complex whether they are being treated in the hospital portion thereof, the Clinic portion thereof, or in both. [A2; A20]

There are very significant medical advantages to patients as a result of the integration and coordination of the health care delivery roles of the Petitioner's hospital and the Clinic. [A20] These advantages include: permitting the patient to receive a full range of health care services at a single facility; allowing the Clinic to serve as the outpatient department of the hospital; permitting close cooperation among all members of the health care team; reduced hospitalizations and lengths of stay; and reduced cost of health care. [A20] Many medical procedures otherwise requiring inpatient care can also be accomplished on an outpatient basis as a result of this medical relationship. [A21]

In addition, one of the primary benefits resulting from the Petitioner's relationship with the Clinic is that the Petitioner is able to provide continuity of care to patients, [A21] i.e., all of an individual's health care needs can be ministered to in one facility, by one group of doctors with immediate access to the entire medical history of the patient both as an inpatient and an outpatient, including pharmaceutical information, from the first day the patient began to receive health care in the Petitioner's medical complex.

One of the Petitioner's health care support services is a hospital pharmacy. The pharmacy provides all pharmaceuticals

administered to patients while receiving treatment in the Petitioner's medical complex, whether as inpatients, outpatients in the hospital portion of the complex, or outpatients in the Clinic portion of the complex. The pharmacy also provides pharmaceuticals to outpatients receiving health care in the Clinic for use off the premises of the medical complex. Except in rare and unusual cases, the pharmacy does not provide pharmaceuticals to individuals who are not receiving treatment in the Petitioner's medical complex. [A22] The pharmacy is an integral part and an important part of Petitioner's activities. [A21]

To insure continuity of medication (i.e., that a given patient receives the identical type of medication as both an inpatient and outpatient), it is important that the Clinic and the hospital receive their drugs from the same source. Because of the pharmacy, certain medical procedures such as hyperalimentation and chemotherapy can be administered in the Petitioner's medical complex on an outpatient instead of inpatient basis. [A21-22] In addition, the pharmacy maintains a patient profile for each patient of the complex to whom it has provided medications. This profile is a listing of the drugs administered or prescriptions filled on both an inpatient and outpatient basis. The patient profile maintained by the pharmacy is an element of continuity of care and as such permits the Petitioner to provide better health care. [A21]

There is a continual flow of patients between the Petitioner's hospital and the Clinic. [A19-20] In the event an outpatient being treated by a Clinic physician requires hospitalization, that patient will be hospitalized at the Petitioner's hospital. [A19] Non-emergency cases seeking access to the Petitioner's medical complex frequently utilize the hospital's emergency room as the access point and are often referred to the Clinic where they can receive care which is less intensive and less costly than the health care available in a hospital emergency room setting. [A20] Hospital inpatients are sometimes transferred to the Clinic for treatment. [A19-20] After an inpatient is discharged any sub-

sequent outpatient care will normally be received at the Clinic. Patients receiving care at the Clinic may as a part of that care also be receiving care in one of the hospital's outpatient therapy departments.

This continual patient flow is at the very heart of the Petitioner's ability to provide continuity of care on both an inpatient and outpatient basis.

ARGUMENT

I

THE ISSUE OF LIABILITY FOR UNRELATED BUSINESS INCOME TAXES ARISING FROM A HOSPITAL'S PERFORMANCE OF AN INTEGRAL HEALTH CARE FUNCTION ON BEHALF OF PATIENTS BEING TREATED UNDER A HOSPITAL SPONSORED AMBULATORY HEALTH CARE DELIVERY SYSTEM IS AN IMPORTANT QUESTION OF FIRST IMPRESSION UNDER THE STATUTE

The Court of Appeals concluded that it is not within the scope of the exempt purposes of a tax exempt hospital to provide an integral health care support service (a pharmacy) to physicians operating outside of the formalistic legal structure of the hospital, and to patients receiving health care from such physicians, in connection with an ambulatory health care delivery system sponsored by the hospital.

The Court of Appeals' decision is premised on artificial legal distinctions which ignore the medical realities existing in most hospitals in today's health care environment. The logical consequence of the Court of Appeals' adoption of these artificial legal distinctions is twofold. First, many activities of tax-exempt hospitals previously considered related to exempt purposes will now become taxable. Second, because the question of tax exemption itself under 26 U. S. C. § 501(c)(3) inherently involves the same related versus unrelated inquiry made by the Court of Appeals under Section 513, that Court's rationale will ultimately result in revocation or denial of the tax exempt status of hospitals which to a significant extent provide health care services through and in cooperation with non-exempt health care providers. Unless the Court corrects this erroneous interpretation of the scope of the exempt purposes of a hospital, the ability of

hospitals to innovate and alter the structure of our health care delivery system to maximize its effectiveness and minimize its cost will be severely impacted.

Since the turn of the century, American community hospitals have moved progressively to become the principal locus for the care of those who are acutely or seriously ill. J. Bryant, *Community Hospitals & Primary Care* ix (1976). As the scientific and technologic capabilities of medical practice have increased, so have hospitals' abilities to offer sophisticated care to those with complex problems requiring hospitalization.

As hospitals began to proliferate and successfully contend episodically with disease, a new and expanded challenge arose. The need to achieve comparable success in responding to the medical needs of non-hospitalized patients became a concern because of ecological, epidemiological, and financial factors. While the health problems presented by the walking ill are usually less life-threatening, they are vastly more common and often times equally anxiety-producing for those seeking care. The demand upon hospitals to play an expanded role in ambulatory care has arisen as the number of primary care physicians—general internists, pediatricians, and family practitioners—has declined. *Id.* As a result, many Americans do not have a personal physician, and are thus using hospital emergency rooms or outpatient departments as a source of general medical services. In 1962, ambulatory visits already outnumbered inpatient admissions 3:1. In the following ten years, ambulatory visits increased one hundred and ten percent (110%) while admissions increased by only twenty-four percent (24%), the ratio between them is widening to almost 5:1. During the same period, the ratio of outpatient visits to inpatient days increased seventy percent. J. Freyman, *The American Health Care System: Its Genesis & Trajectory* 233 (1977).

This increase in utilization of outpatient services has been caused in part by the increasing cost of inpatient care. In 1969, a study was completed utilizing regression methods to estimate

the demand function for outpatient visits in forty-eight states. This study provided evidence that frequency of outpatient visits is a function of rising inpatient prices and the relatively low cost of care provided in an outpatient setting. Davis & Russel, *The Substitution of Hospital Outpatient Care for Inpatient Care*, 2 REV. OF ECON. & STAT. 109 (1972). It follows that factors, such as the absorption of the cost of a tax on pharmaceuticals by outpatients, which tend to increase the total charge for an outpatient visit can have a profound inhibiting effect on the utilization of outpatient services despite the cost effectiveness of this alternative vis-a-vis inpatient services.

The Court of Appeals in reaching its conclusion that the pharmacy sales at issue are unrelated to the Petitioner's exempt purposes is necessarily denying the existence of not only a patient relationship between the Petitioner and the individual outpatient but also any type of medical relationship between the Petitioner, the Clinic and such outpatients. The Court of Appeals viewed the for-profit nature of the Clinic as somehow automatically precluding any such relationship within the intendment of the Petitioner's exempt purposes. Such a position is based on a total lack of understanding of the complexities of delivering health care. The Petitioner has not abrogated its health care responsibilities by its relationship with the Clinic and the Clinic's serving as its outpatient department. On the contrary, the Petitioner has expanded substantially those responsibilities. The Court of Appeals' decision, raising exposure to both tax and exemption problems for hospitals, will unnecessarily impede the development of working relationships between exempt and tax paying health care providers to the ultimate detriment of the individual American citizen.

There are few cases which address the scope of permissible activities of a tax exempt hospital under the Internal Revenue Code; there are no cases which address the effect under the unrelated trade or business sections of the Internal Revenue Code, 26 U.S. C. §§ 511-513, of a tax exempt hospital coordinating its

delivery of health care with a for-profit entity to improve the quality of such health care and reduce the cost thereof. This is an important area of the law as is evidenced by the massive Presidential and Congressional effort extending over several years to improve the health of the American public and at the same time reduce the rapidly escalating costs of delivering health care. The Court of Appeals' erroneous intepretation of 26 U. S. C. § 513 in such a significant area of law creates a dangerous precedent which must be corrected and justifies the grant of certiorari to review the judgment below.

II

THE ADOPTION OF UNFAIR COMPETITION AS THE PRIMARY CRITERION FOR DETERMINING WHETHER AN ACTIVITY CONSTITUTES AN UNRELATED TRADE OR BUSINESS IS AN IMPORTANT QUESTION FOR SUBSTANTIALLY ALL TAX EXEMPT ORGANIZATIONS

The definition of an unrelated trade or business is set forth in 26 U. S. C. § 513 and is developed in substantial detail in Treasury Regulations. In order for an activity to constitute an unrelated trade or business, it must meet three criteria. First, the activity must constitute a trade or business. Second, it must be regularly carried on. Third, it must not be "substantially related" to the exempt purposes of the organization engaging in the activity. This last criterion is the most important of the three and is the only one in question in the instant case.

Treas. Reg. § 1.513-1(d)(2) elaborates on the subtantially related test as follows:

> "Trade or business is 'related' to exempt purposes, in the relevant sense, only where the conduct of the business activities has causal relationship to the achievement of exempt purposes (other than through the production of income); and it is 'substantially related,' for purposes of section 513, only if the causal relationship is a substantial one. Thus, for the conduct of trade or business from which a particular

> amount of gross income is derived to be substantially related to purposes for which exemption is granted, the production or distribution of the goods or the performance of the services from which the gross income is derived must *contribute importantly* to the accomplishment of those purposes."

Treas. Reg. § 1.513-1(d)(2) (1975) (emphasis added).

The Court of Appeals, while paying lip service to the substantially related test, in fact totally ignored the qualitative inquiry required by the statute and the Treasury Regulations with respect to the effect of the questioned activity on exempt purposes. In place of this qualitative inquiry the Court of Appeals adopted the factor of unfair competition—which in fact *automatically* exists in *all* cases when an exempt organization competes with a for-profit taxpayer—as being the primary consideration under the statute. The Court of Appeals' narrow focus on the profits realized by the Petitioner from the pharmacy sales in question, its virtual equating of these profits with a business motive, and its reliance on its own narrow reading of the legislative history of the unrelated business income tax provisions, all form the basis for the Court's unusual approach. While applied to the Petitioner in the instant case, this approach is verbalized most clearly in the Court of Appeals' subsequent opinion in the *Hope School* v. *United States,* 612 F. 2d 298, 80-1 U. S. T. C. ¶ 9134 (7th Cir. 1980), which case was argued immediately before the Petitioner's case, wherein the Court states as follows:

> The Government urges, however, that unfair competition is not the proper touchstone for our analysis because of the decision in *Clarence LaBelle Post No. 217* v. *U. S.,* 580 F. 2d 270 (8th Cir.), cert. dismissed, 99 S. Ct. 712 (1978). In *LaBelle,* the Eighth Circuit held that unfair competition is not the sole criterion to be considered in applying the unrelated business tax. Although the issue before it was whether the proceeds of bingo games should be taxed, the court referred in its analysis to the 'low cost articles' exemption:

> "The references to competition serve merely to explain reasons why an activity that lacks a commercial orientation should not be considered a 'trade or business' under either Section 162 or Section 513. Under the regulation, competition alone does not determine whether an unrelated trade or business should be taxed."

580 F. 2d at 274. To the extent the court held that unfair competition is not the only factor to be considered, we support its holding. See *Carle Foundation* v. *U. S.*, No. 79-1273, 611 F. 2d 1192 at 1196 n. 6 (7th Cir. 1979). However, to the extent that *LaBelle* may hold that unfair competition is not the primary consideration, we disagree.

* * * * *

> This evidence in the legislative history, coupled with the Service's express mention of unfair competion in the context of the 'low cost articles' exception supports our conclusion that unfair competition is the key to whether the activities of the Hope School *constitute an unrelated trade or business as a matter of law.*

612 F. 2d 298, 304, 80-1 U. S. T. C. ¶ 9134 at 83,111 (emphasis added).

Unless the Court corrects this patently erroneous interpretation of the unrelated trade or business provisions of the Internal Revenue Code perfectly proper and acceptable income producing activities engaged in by tax exempt organizations of all types, not just hospitals, will be seriously threatened with taxation.

Tax exemption is extended to organizations under 26 U. S. C. § 501(c)(3) upon the theory that:

> "The Government is compensated for the loss of revenue by its relief from financial burdens which would otherwise have to be met by appropriations from public funds, and by the benefits resulting from a promotion of the general welfare."

Report of a Ways and Means Subcommittee, 75th Cong., 3rd Sess. [to accompany a Proposed Revision of the Revenue Laws

(1938)]. *See also* H. R. No. 1860, 81st Cong., 2d Sess. [to accompany H. R. 9682].

In 1950, Congress determined that tax exemptions were being abused by organizations engaging in commercial activities unrelated to their tax exempt purposes beyond producing income for use in connection with such purposes. These activities were in direct competition with taxpaying entities. Given the lack of any relationship between the activities and the tax exempt purposes of the organizations engaging therein Congress found no reason to permit the tax exemption to shelter such activities from taxation. *See* H. R. No. 2319, 81st Cong., 2d Sess., *reprinted in* 1950-2 C. B. 380 *and* S. Rep. No. 2375, 81st Cong., 2d Sess., *reprinted in* 1950-2 C. B. 483 and [1950] U. S. Code Cong. & Ad. News 3053, 3081.

Two things are quite clear from the legislative history. First, it was the exemption of business profits from taxation which rendered competition by an exempt organization with a taxable organization unfair. Second, competition between exempt organizations and taxpaying entities, even though unfair, is not intended to render an activity taxable unless the activity is unrelated to the exempt organization's purposes. By adopting unfair competition as the primary consideration in applying the unrelated trade or business test the Court of Appeals is *automatically* condemning to taxation *any* trade or business regularly engaged in by a tax exempt organization. By definition, competition between a tax exempt organization and a taxpaying entity is inherently unfair by virtue of the tax exemption. Therefore, under the Court of Appeals' formulation of the test, the statutory definition becomes meaningless and substantially all tax-exempt organizations must fear a significant loss of revenue through taxation of heretofore tax exempt business activities which contribute importantly to their exempt purposes.

The problem created by the Court of Appeals' misconstruction of Section 513 goes beyond the question of taxation of some of the income of exempt organizations. The question of

what activities are in furtherance of an exempt organization's purposes and what activities are not in furtherance thereof is also inherently a necessary inquiry when considering the initial granting or continuance of an exemption under 26 U. S. C. § 501. A tax exemption obviously cannot be premised on the basis of an activity which constitutes an unrelated trade or business. Accordingly, if the Court of Appeals' erroneous construction of Section 513 is carried over into an analysis under Section 501, the tax exemption granting provision, the tax exemptions of numerous organizations will be adversely affected.

The Court of Appeals' erroneous interpretation of 26 U. S. C. § 513, applicable to virtually the entire tax-exempt community, constitutes a direct threat to the economic stability of vast numbers of exempt organizations and is therefore dangerous precedent which must be corrected and justifies the grant of certiorari to review the judgment below.

III

THE COURT OF APPEALS' DECISION INTERPETING THE "SUBSTANTIALLY RELATED" CONDITION OF 26 U. S. C. § 513 CONFLICTS WITH THE DECISIONS OF NUMEROUS OTHER LOWER COURTS

26 U. S. C. § 511(a)(1) imposes a tax on the "unrelated business taxable income" of most tax-exempt organizations. 26 U. S. C. § 512(a)(1) defines the term "unrelated business taxable income" as meaning:

> [T]he gross income derived by any organization from any unrelated trade or business (as defined in section 513) regularly carried on by it . .

26 U. S. C. § 512(a)(1). 26 U. S. C. § 513(a) provides that the term "unrelated trade or business" means:

> [I]n the case of any organization subject to the tax imposed by section 511, any trade or business the conduct of which is not substantially related . . . to the exercise or perform-

> ance by such organization of its charitable, educational or other purpose or function constituting the basis for its exemption under section 501 . . .

26 U. S. C. § 513(a).

The Court of Appeals focused its attention almost exclusively on the profits realized by the Petitioner from the portion of the pharmacy activity in question. In this regard, it stated that:

> Although not absolutely conclusive, these substantial profits appear to contribute importantly to a business rather than to an exempt purpose and clothe this portion of the Pharmacy's activities with the attributes of a commercial enterprise.

611 F. 2d 1192, as modified [A16]. The legislative history of the unrelated business income tax provisions makes it clear that Congress sought to remedy the abuse which arose as a result of an exempt organization's ability to earn profits without paying tax thereon while engaging in an activity directly in competition with taxpaying entities. Congress deemed this to be a form of "unfair competition" and sought to correct this abuse through the unrelated business income tax provisions by the weighing or balancing of this unfair competition against the degree to which the activity furthers the organization's exempt purposes. The Court of Appeals' narrow focus on the profits realized from the pharmacy activity, considered in the context of the abuse which Congress sought to rectify, demonstrates that the Court of Appeals adopted the factor of "unfair competition" as being the primary criterion for determining the existence of an unrelated trade or business. This is made abundantly clear by the Court of Appeals itself in *Hope School* v. *United States,* 612 F. 2d 298, 80-1 U. S. T. C. ¶ 9134 (7th Cir. 1980), as discussed *supra* p. 10. The Court of Appeals' interpretation of 26 U. S. C. § 513 totally ignores the statutory language and is in conflict with numerous decisions of other lower courts.

In *Smith-Dodd Businessman's Association, Inc.* v. *Commissioner,* 65 T. C. 620 (1975), the United States Tax Court con-

sidered the unrelated trade or business status of a bingo game conducted by an exempt organization in a state where only tax-exempt, nonprofit organizations could be licensed to operate such games. In other words, the Tax Court was faced with a situation where the activity could not possibly be in competition with a taxpaying entity. Nonetheless, it held the activity to constitute an unrelated trade or business, stating:

> The *Greene County Medical Society Found.* case involved the years, 1964, 1965, and 1966, prior to the effective date of the extensive amendments of the unrelated business tax provisions included in the Tax Reform Act of 1969 and, for this reason, provides little help in deciding the instant case. It is true that the court in that case emphasized the absence of any unfair competition flowing from that exempt organization's activities. However, *unfair competition plays a relatively insignificant role in the application of the amended unrelated business tax,* as shown by the following provisions of section 1.513-1(b), Income Tax Regs.:
>
> > "In general, any activity of a section 511 organization which is carried on for the production of income and which otherwise possesses the characteristics required to constitute 'trade or business' within the meaning of section 162—and which, in addition, is not substantially related to the performance of exempt functions—presents sufficient likelihood of unfair competition to be within the policy of the tax. * * *"

65 T. C. 624 (emphasis added).

Citing *Smith-Dodd Businessman's Association* and expressly adopting the reasoning of that decision that unfair competition plays a relatively insignificant role in the application of the amended unrelated business tax, the Eighth Circuit in considering an identical factual situation in *Clarence LaBelle Post No. 217* v. *U. S.*, 580 F. 2d 270, 273, 78-2 U. S. T. C. ¶ 9496 (8th Cir.), *cert. dismissed* 439 U. S. 1040 (1978), also held that the bingo activity there in question constituted an unrelated trade or business.

Clarence LaBelle Post No. 217 and *Smith-Dodd Businessman's Association* are clear holdings that unfair competition is not the primary consideration for determining the existence of an unrelated trade or business under 26 U. S. C. § 513. The Court of Appeals' decision in the instant case is directly in conflict with the decisions of these two other lower courts.

The Court of Appeals' decision also conflicts with numerous other lower court decisions where competition or the lack thereof was not even mentioned as a factor in determining whether the activity in question constituted an unrelated trade or business. *See e.g., San Antonio District Dental Society* v. *United States,* 340 F. Supp. 11, 72-1 U. S. T. C. ¶ 9248 (W. D. Tex. 1972); *Oklahoma Cattlemen's Association, Inc.* v. *United States,* 310 F. Supp. 320, 70-1 U. S. T. C. ¶ 9165 (W. D. Okla. 1969); *Mobile Arts & Sports Association, Inc.* v. *United States,* 148 F. Supp. 311, 57-1 U. S. T. C. ¶ 9359 (S. D. Ala. 1957); *Maryland State Fair & Agricultural Society, Inc.* v. *United States,* 55-1 U. S. T. C. ¶ 9399 (D. C. Md.). *See also, Anateus Lineal 1948, Inc.* v. *United States,* 366 F. Supp. 118 (E. D. Ark. 1973).

Finally, the Court of Appeals decision is also in conflict with numerous cases decided under 26 U. S. C. § 501(c)(3) recognizing the tax-exempt status of various organizations. In order to qualify for exemption, an organization's purpose must be to engage exclusively in one or more exempt purposes. If the activity engaged in would constitute an unrelated trade or business under 26 U. S. C. §§ 511-513, it automatically follows that the organization could not qualify for exemption. Nonetheless, numerous courts have upheld the tax exempt status of various organizations under Section 501(c)(3) where the organizations engaged in activities which clearly competed with taxpaying entities. While the question at issue in these cases was one of exemption under Section 501(c)(3) and not taxability under Sections 511-513 the courts necessarily had to conclude that the activities engaged in were proper exempt activities and not

unrelated trades or businesses. *See Better Business Bureau* v. *United States*, 326 U. S. 279, 283 (1945). Decisions upholding exemption in the face of substantial activities in competition with taxpaying businesses are therefore directly in conflict with the Court of Appeals' decision in the instant case. *See, e.g., B. H. W. Anesthesia Foundation, Inc.* v. *Commissioner*, 72 T. C. 681 (1979); *People's Translation Service* v. *Commissioner*, 72 T. C. 42 (1979); *Afro-American Purchasing Center, Inc.* v. *Commissioner*, T. C. Memo. 1978-31, 37 T. C. M. (CCH) 184 (1978); *Metropolitan Detroit Area Hospital Services, Inc.* v. *United States of America*, 445 F. Supp. 857, 78-1 U. S. T. C. ¶ 9256 (E. D. Mich. 1978).

Not only is the Court of Appeals' decision in conflict with the decisions of numerous other lower courts with respect to the standard to be applied under 26 U. S. C. § 513 but even its treatment of the application of that standard as a matter of law rather than a question of fact is in conflict with other lower courts. While not expressly addressing the question in the instant case, the Court of Appeals in *Hope School* v. *United States*, 612 F. 2d 298, 80-1 U. S. T. C. ¶ 9134 (7th Cir. 1980), an unrelated business income case argued immediately before the *Carle* case and the opinion in which was issued shortly after the *Carle* opinion, states that:

> This evidence in the legislative history coupled with the Service's express mention of unfair competition in the context of the 'low cost articles' exception supports our conclusion that unfair competition is the key to whether the activities of the Hope School constitute an unrelated trade or business *as a matter of law.*

612 F. 2d 298, 304, 80-1 U. S. T. C. ¶ 9134 at 83,111 (emphasis added).

We must assume that the Court of Appeals was consistent in its treatment of the substantially related inquiry as a question of law in the instant case. This is in direct conflict with *Parker* v. *Commissioner*, 365 F. 2d 792, 66-2 U. S. T. C.

¶ 9647 (8th Cir. 1966), *cert. denied*, 385 U. S. 1026 (1967), where the required inquiry is properly treated as a question of fact.

CONCLUSION

For these reasons, a writ of certiorari should issue to review the judgment and opinion of the Seventh Circuit Court of Appeals.

Respectfully submitted,

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April 29, 1980

APPENDIX.

IN THE UNITED STATES COURT OF APPEALS
For the Seventh Circuit

No. 79-1273

CARLE FOUNDATION, an Illinois not for profit corporation,

Plaintiff-Appellee,

vs.

UNITED STATES OF AMERICA,

Defendant-Appellant.

Appeal from the United States District Court for the Eastern District of Illinois, Danville Division.
No. 75 C 2148—Henry S. Wise, *Judge.*

ARGUED SEPTEMBER 12, 1979—DECIDED NOVEMBER 29, 1979

Before FAIRCHILD, *Chief Judge,* SWYGERT and SPRECHER, *Circuit Judges.*

SPRECHER, *Circuit Judge.* The question raised in this appeal is whether the sales by a tax-exempt hospital pharmacy to a nonexempt clinic and to the clinic's private patients give rise to unrelated business taxable income. We hold that they do and therefore reverse the judgment of the lower court.

I

The Carle Foundation, which is composed of the Carle Foundation Hospital and the Carle Foundation Pharmacy, has

been exempt from federal income taxes since 1949 under 26 U. S. C. § 501(c)(3) and its predecessor statute. The Foundation rents out office space within its complex to the Carle Clinic Association, a private enterprise run by doctors who engage in the practice of medicine on a for-profit basis. The Clinic has never been, nor has it requested to be, a tax-exempt organization.

With the exception of a small courtesy staff, the Foundation Hospital is staffed entirely by doctors from the Clinic. The doctors are not employees of the Hospital; they are employees of the Clinic, where they pursue private practice. In addition to the identity of medical staff, the proximity of the Hospital and Clinic results in their also sharing some physical facilities, equipment and services. For example, the medical records for all patients in the complex are kept by Hospital personnel and are centrally located in the Clinic area of the compound. Moreover, Clinic facilities are used for laboratory testing, radiological services, electrocardiograms, electroencephalograms and radioisotope testing for patients of the Hospital as well as for private patients of the Clinic. Since their doctors are affiliated with the Foundation Hospital, Clinic patients who require hospitalization are admitted to that hospital. Yet, despite these shared facilities and services, the Clinic and Hospital are distinct legal entities.

The Hospital Pharmacy, part of the tax-exempt Foundation, supplies pharmaceuticals to the Hospital as well as to the Clinic and to some of the Clinic's private patients.[1] Because of these sales to other than the Hospital and its patients, the Internal Revenue Service assessed against the Foundation a $67,266.51 deficiency for the tax years 1971 and 1972. The Foundation paid the assessment and instituted this refund action. The lower court granted the refund with respect to the sale proceeds from

1. The Pharmacy also made pharmaceutical sales to certain nursing home patients and a few non-pharmaceutical sales which the lower court found to be unrelated business taxable income. The Foundation has not appealed that ruling.

the Clinic and its patients, holding that those sales were substantially related to the tax exempt purpose of the Foundation and therefore did not generate unrelated business taxable income. The Government appealed.

II

The Government argues that the sale of pharmaceuticals to the Clinic and its private patients constitutes an unrelated trade or business and is therefore taxable under sections 511-13 of the Internal Revenue Code of 1954, 26 U. S. C. §§ 511-13. In essence, those sections provide that an organization shall be taxed on income from a regularly operated trade or business which is unrelated to its tax-exempt purpose. There is no dispute that the Pharmacy conducts a trade or business; rather, the Government argues that these sales by the Pharmacy are "unrelated."

Section 513(a) defines "unrelated trade or business," in pertinent part, as:

> [A]ny trade or business the conduct of which is not *substantially related* . . . to the exercise or performance by such organization of its . . . purpose or function constituting the basis for its exemption under section 501 . . . except that such term does not include any trade or business—
>
> * * * * *
>
> (2) which is carried on, in the case of an organization described in section 501(c)(3) . . . by the organization primarily for the convenience of its . . . patients . . . .

26 U. S. C. § 513(a) (emphasis added).

We will first address the finding by the lower court "that prescription sales to Clinic outpatients and wholesale [drug sales] to the Clinic . . . have been amply demonstrated to be carried out primarily for the convenience of [the Foundation's] patients," within the meaning of section 513(a)(2). App. 255.[2]

2. Reference to the Government's appendix will hereinafter be cited as "App. ....."

Although the lower court alluded to the 1968 Revenue Rulings which dealt with the conditions under which pharmaceutical sales by an exempt hospital will constitute unrelated business income, it did not address itself specifically to an analysis of Rev. Rul. 68-376, 1968-2 C. B. 246, which gives examples of "patients" within the meaning of section 513(a)(2). Since revenue rulings are to be given weight by the courts, *McMartin Industries, Inc.* v. *Vinal*, 441 F. 2d 1274, 1275-76 (8th Cir. 1971), we must closely analyze the ruling.

The Service listed six examples of relationships that determine whether a person is a "patient": (1) a person admitted to a hospital as an inpatient; (2) a person receiving general or emergency diagnostic, therapeutic, or preventive health services from outpatient facilities of a hospital; (3) a person directly referred to the hospital's outpatient facilities by his private physician for specific diagnostic or treatment procedures; (4) a person refilling a prescription written during the course of his treatment as a patient of the hospital; (5) a person receiving medical services as part of a hospital administered home care program; and (6) a person receiving medical care and services in a hospital affiliated extended care facility. 1968-2 C. B. at 247. In its brief, the Foundation asserts that example (3) is indistinguishable from the situation in this case. See Br. 38.[3] We disagree.

In an explanation of situation (3), the Service gave the following hypothetical fact situation:

> *C*'s private physician refers him to the hospital's outpatient diagnostic facilities for a specific diagnostic procedure. The procedure is administered by a hospital-based practitioner affiliated with the hospital. The availability of these diagnostic procedures is an integral part of the services offered by the hospital. *C* is a patient of the hospital.

1968-2 C. B. at 247.

---

3. Brief for the Foundation will hereinafter be cited as "Br. ....."

Based on that hypothetical, the Foundation argues that the Clinic falls within the ambit of the Revenue Ruling because it "is certainly affiliated with" and is "the outpatient department of" the Hospital. Br. 38. Although somewhat appealing at first blush, the fallacy in the Foundation's argument becomes apparent upon a closer examination. On the one hand, the Foundation is urging that, because the Clinic provides outpatient testing for the Hospital,[4] the Hospital and Clinic are a single legal entity. But clearly the are not. The Pharmacy and Hospital are part of a tax-exempt endeavor, while the Clinic is a for-profit, private tax paying enterprise. Indeed, as the Government points out in its brief, if the Hospital and Clinic were operated as a single entity, then that entity could not qualify for tax exemption under section 501(c)(3) because of the inurement to private individuals of part of the earnings. Gov't 10.[5] See *Harding Hospital, Inc.* v. *U. S.*, 505 F. 2d 1068, 1078 (6th Cir. 1974).

On the other hand, the Foundation appears to be urging that, for some purposes, its outpatient testing department is *separate* from the Clinic itself. Its argument can be broken down as follows: (1) the Revenue Ruling states that patients referred by their private physicians to the outpatient clinic of a hospital are considered patients of the hospital; (2) the Carle Clinic is staffed by private physicians; (3) when Carle Clinic physicians prescribe diagnostic testing for their patients, it is performed at the Clinic; (4) the Carle Clinic provides outpatient testing services for the Hospital; (5) therefore, under the Revenue Ruling, the Clinic's private patients who receive diagnostic testing must be considered patients of the Hospital. That argument clearly misapprehends the import of the ruling. The Revenue Ruling

4. There is no question that Hospital patients using Clinic testing facilities are nevertheless patients of the Hospital so that the sale of pharmaceuticals to them does not constitute unrelated business income. The Government recognized this from the outset and never tried to tax that income. Moreover, the Government has not sought to tax proceeds from sales to Hospital-originated Clinic patients.

5. Brief for the Government will hereinafter be cited as "Gov't ....."

contemplates the private physician's referring his patient to an outpatient diagnostic facility which is part of a hospital and separate from the physician's private clinic. The mere fact that the Clinic does some testing for Hospital patients cannot transform the Clinic facilities into a part of the Hospital. Likewise, the mere fact that the Clinic does some testing for Hospital patients cannot transform the Clinic's private patients who receive diagnostic testing into "Hospital patients."

The other examples given in the Revenue Ruling are more obviously inapplicable. There is no controversy here about the status, for tax purposes, of any inpatient of the Hospital. Likewise, emergency room patients, former inpatients refilling a prescription, patients in hospital administered home care programs and patients in hospital-affiliated extended care facilities are not in issue here.

III

Having determined that sales to the Clinic and its private patients are not exempt from unrelated business tax as "primarily for the convenience of its . . . patients," we next turn our attention to whether those sales were nevertheless substantially related to the tax exempt purposes of the Foundation. In its exemption affidavit submitted to the Internal Revenue Service in 1948, the Foundation stated its purposes as follows:

> Conducting a hospital for the treatment of sick and disabled persons; engaging in scientific research in the causes and treatment of human diseases; training of internes [*sic*], resident physicians, surgeons, laboratory technicians, pathologists, and nurses in the scientific diagnosis and hygienic care of sick and disabled persons.

App. 237. Contrary to the conclusion reached by the lower court and the argument advanced by the Foundation, we cannot stretch our analysis to find pharmaceutical sales to the Clinic and its private patients "substantially related" to any of the stated exempt purposes of the Foundation.

There is very little jurisprudence on which activities will meet the "substantially related" test. Consequently our analysis must begin with the Treasury Regulations. It is well established that the regulations must be given great weight absent a showing that they are unreasonable or inconsistent with congressional intent. See, e.g., *Commissioner* v. *South Texas Lumber Co.*, 333 U. S. 496, 501 (1948); *Fawcus Machine Co.* v. *U. S.*, 282 U. S. 375, 378 (1931). Since we believe the relevant regulations to be wholly consistent with congressional intent in enacting the revenue statutes in question,[6] we turn our attention to the language of the regulations.

26 C. F. R. § 1.513-2(a)(4) reads in pertinent part:

> [A] trade or business is substantially related to the activities for which an organization is granted exemption if the principal purpose of such trade or business is to further . . . the purpose for which the organization is granted exemption. In the usual case the nature and size of the trade or business must be compared with the nature and extent of the activities for which the organization is granted exemption in order to determine whether the principal purpose of such trade or business is to further . . . the purpose for which the organization is granted exemption.

---

6. The unrelated business tax provisions were passed by Congress as part of the Revenue Act of 1950. The Senate Report accompanying the bill states in pertinent part:

> The problem at which the tax on unrelated business income is directed is primarily that of unfair competition. The tax-free status of section 101 [now section 501] organizations enables them to use their profits tax-free to expand operations, while their competitors can expand only with the profits remaining after taxes.

Sen. Rep. No. 2375, 81st Cong. 2d Sess. (1950), *reprinted in* 1950-2 U. S. Code Cong. Serv. 3053, 3081.

Although some courts have held, and we agree, that the elimination of unfair competition is not the *sole* factor to be weighed, see *Clarence LaBelle Post No. 217* v. *U. S.*, 580 F. 2d 270, 271-74 (8th Cir. 1978), it is very important in determining whether a given activity is to be taxed as an unrelated trade or business.

26 C. F. R. § 1.513-1(b) elaborates on the above test, enunciating the policy behind finding an activity to be an unrelated trade or business:

> The primary objective of adoption of the unrelated business income tax was to eliminate a source of unfair competition by placing the unrelated business activities of certain exempt organizations upon the same tax basis as the non-exempt business endeavors with which they compete. . . . [I]n general, any activity of a [tax-exempt] organization which is carried on for the production of income and which otherwise possesses the characteristics required to constitute "trade or business" . . . and which, in addition, is not substantially related to the performance of exempt functions—presents sufficient likelihood of unfair competition to be within the policy of the tax. . . . Activities . . . from which a particular amount of gross income is derived do not lose identity as a trade or business merely because they are carried on within a larger aggregate of similar activities . . . which may . . . be related to the exempt purposes of the organization. Thus, for example, *the regular sale of pharmaceutical supplies to the general public by a hospital pharmacy does not lose identity as a trade or business merely because the pharmacy also furnished supplies to the hospital and patients of the hospital in accordance with its exempt purposes.* . . .

(Emphasis added).

In *Iowa State University of Science and Technology* v. *U. S.*, 500 F. 2d 508 (Ct. Cl. 1974), the court applied the unrelated business tax regulations to a situation analogous to the one in this case. A tax-exempt university owned and operated a television station which produced substantial revenues for the school. In holding those revenues to be unrelated business income, the court stated that to determine whether a trade or business was substantially related to an organization's exempt purpose, the relevant test under the regulations is "a comparison of the nature and size of the commercial . . . operations with the extent and scope of its [exempt] operations." *Id.* at 517. In determining

whether a business purpose is paramount over an exempt purpose the court stated:

> Profits are, although not conclusive, at least some evidence that the business purpose is primary. American Institute for Economic Research v. United States, 302 F.2d 934, 938, 157 Ct. Cl. 548, 556 (1962), cert. denied, 372 U.S. 976, 83 S.Ct. 1109, 10 L.Ed.2d 142 (1963). Very substantial profits . . . are also not conclusive but do constitute some evidence indicative of a commercial enterprise. Scripture Press Foundation v. United States, 152 Ct. Cl. 463, 468, 470, 285 F.2d 800, 803, 806 (1961), cert. denied, 368 U.S. 985, 82 S.Ct. 597, 7 L.Ed.2d 523 (1962).
>
> * * * * *
>
> As pointed out above, however, the presence of a profit motivation is not wholly determinative of the issue. Of greater importance is the manner in which the enterprise is conducted; a profitable operation may be justified by factors which, on balance, show that the conduct of the business was substantially related to the exempt purpose of the institution.

Id. at 517-18. Finding the operations of the television station *not* substantially related to the university's exempt purpose, the court held that the predominant characteristic of the station was that of a "commercial" enterprise. *Id.* at 519.

Measured against the guidelines articulated in *Iowa State* and in the regulations, we find that the pharmaceutical sales which form the basis of this appeal are not substantially related to the Foundation's exempt purpose. For sales to the Clinic and its private patients, the Pharmacy is in direct competition with its nonexempt counterparts. Indeed, for the tax years in question, the Pharmacy grossed over $800,000 from sales to other than the exempt Hospital and its patients, resulting in close to $150,000 of income for the Foundation. App. 250. Although not absolutely conclusive, these substantial profits indicate a business rather than an exempt purpose and clothe this portion of the Pharmacy's activities with the attributes of a commercial

enterprise. To the extent that they are conducted in the same manner as a commercial enterprise, we hold that the activities of the Carle Foundation Pharmacy constitute an unrelated trade or business within the meaning of 26 U. S. C. §§ 511-13.

IV

The Foundation places much emphasis in its brief on Revenue Ruling 69-463, 1969-2 C. B. 131, where the Service concluded that the leasing by a hospital of office space to a for-profit medical group did not constitute an unrelated trade or business. Particular importance is attached to the portion of the ruling which states:

> The hospital has established that the presence of the group practice at the hospital has had the effect of . . . fulfilling the hospital's role as the health center of the community. . . .
>
> * * * * *
>
> It is held that the group practice described above contributes importantly to the hospital's operations and is therefore substantially related to the carrying on of hospital functions.

1969-2 C. B. at 131. Despite the Foundation's reliance on this ruling, we do not find it to support the broad proposition that all business dealings between an exempt hospital and a non-exempt but closely related clinic are necessarily related to the tax-exempt purpose of the hospital. The stated purpose of the Foundation is to conduct "a hospital for the treatment of sick and disabled persons." App. 237. There is no evidence that the sale of pharmaceuticals to the Clinic and its private patients substantially furthers that purpose. Unlike the situation addressed in the ruling, the sale of pharmaceuticals to the Clinic and its patients was not an inducement to the Clinic to locate in the Foundation medical complex and is not substantially related to providing health care to the Hospital's patients.

Similarly, the Foundation's reliance on three other Revenue Rulings is misplaced. Revenue Ruling 69-267, 1969-1 C. B. 160, concluded that a hospital gift shop, which was patronized by patients, visitors making purchases for patients, and employees, was substantially related to the hospital's exempt function because it provided "a facility . . . to improve the physical comfort and mental well-being of [the hospital's] patients." *Id.* Contrary to the Foundation's position, the sale of pharmaceuticals to the Clinic and its private patients cannot be analogized to sales to or for the benefit of hospital inpatients. Moreover, while gift shop sales to hospital employees keep "employees and medical staff on [hospital] premises throughout their working days," thereby "increas[ing] the hospital's efficiency," no such overriding considerations are present in this case.

Likewise, both the operation of a cafeteria and coffee shop for employees, medical staff and persons visiting patients, Rev. Rul. 69-268, 1969-1 C. B. 160, and the operation of a parking lot for patients and visitors, Rev. Rul. 69-269, 1969-1 C. B. 160 are clearly distinguishable from the sales which form the basis of this appeal. As with the income derived from the gift shop, the proceeds received from the operation of the cafeteria and parking lot were substantially related to the hospital's exempt purpose because they facilitated visits to patients by friends and relatives, constituting "supportive therapy that assists in patient treatment and encourages their recovery." Rev. Rul. 69-268, 1969-1 C. B. at 160. No such benefits are derived by Foundation Hospital patients from the sale of pharmaceuticals to the Clinic and its patients.

This case is more similar to the one addressed in Revenue Ruling 68-375, 1968-2 C. B. 245. Contrary to the conclusion reached by the lower court, we do not find the facts of that ruling materially different from the facts here. In the ruling, a hospital owned an adjacent medical office building which it leased to some members of its medical staff. The patients treated at the office building were, like the Carle Clinic patients, their

physicians' private patients. As with the Foundation Hospital, the hospital in the ruling did not have governing authority over the treatment of patients by physicians in their private offices.

The hospital operated a pharmacy in the office building, primarily for the convenience of the patients of the doctors in the office building. The Service found that the sales to those private patients resulted in unrelated business income for the hospital. Since pharmaceutical supplies were purchased "as an incident to the purchaser's visit to his private physician, rather than as an incident to his use of any of the hospital facilities," the Service concluded that those sales were not substantially related to the tax-exempt purpose of the hospital. 1968-2 C. B. at 246. By the same token, we find that the sale of pharmaceuticals to the Clinic and its patients are not incidental to the use of the Hospital facilities and are not substantially related to the purposes of the Foundation.

The Foundation urges, however, that the sale of pharmaceuticals to Clinic patients furthers its tax-exempt purpose because of the "continual flow of patients between the Hospital and the Clinic. In the event an outpatient being treated by a Clinic physician requires hospitalization, that patient will be hospitalized at the Hospital." Br. at 8. We do not find that fact to provide the link necessary to meet the "substantially related" test. Indeed, the same argument could be made with respect to the situation addressed in Revenue Ruling 68-375. While it is undoubtedly true that a private patient requiring hospitalization will be admitted to the hospital with which his physician is affiliated, that characteristic is not unique to the Carle Clinic/Carle Foundation Hospital relationship. The fact remains that the pharmaceuticals in question, like the pharmaceuticals in the ruling, were purchased "as an incident to the purchaser's visit to his private physician rather than as an incident to his use of any hospital facilities." It is immaterial that the pharmacy in the ruling sold primarily to patients of the private doctors, while the Foundation Pharmacy made most of its sales to the exempt

Hospital and its patients. In the ruling, the Service only classified as an unrelated business the pharmacy's sales to the private patients. Similarly, the only sales in this case which constitute an unrelated business are those to the Clinic and its patients. Moreover, the unrelated sales by the Foundation Pharmacy, although not predominant are quite substantial.

Accordingly, we find the judgment of the lower court to be clearly erroneous and hold that the Foundation is not entitled to a refund of the unrelated business income taxes paid by it for the tax years 1971 and 1972.

REVERSED.

A true Copy:

Teste:

.....

Clerk of the United States Court of Appeals for the Seventh Circuit

UNITED STATES COURT OF APPEALS
For the Seventh Circuit
Chicago, Illinois 60604

February 1, 1980.

Before

Hon. Thomas E. Fairchild, *Chief Judge*
Hon. Luther M. Swygert, *Circuit Judge*
Hon. Robert A. Sprecher, *Circuit Judge*

CARLE FOUNDATION, an Illinois not for profit corporation,
Plaintiff-Appellee,

No. 79-1273 *vs.*

UNITED STATES OF AMERICA,
Defendant-Appellant.

Appeal from the United States District Court for the Eastern District of Illinois, Danville Division.

No. 75 C 2148
Henry S. Wise,
Judge.

ORDER ON PETITION FOR REHEARING.

The opinion in this case issued November 29, 1979 is modified as follows:

1. On page 7, line 9, for "26 C. F. R. § 1.513-2(a)(4)" read

26 C. F. R. § 1.513-1(d)

2. On page 7, delete all of lines 10 through 21 and add:

(2) *Type of relationship required.* Trade or business is "related" to exempt purposes, in the relevant sense, only where the conduct of the business activities has causal relationship to the achievement of exempt purposes . . .; and it is "substantially related," . . . only if the causal

relationship is a substantial one. . . . [T]he performance of the services from which the gross income is derived must contribute importantly to the accomplishment of those purposes. . . .

(3) *Size and extent of activities.* In determining whether activities contribute importantly to the accomplishment of an exempt purpose, the size and extent of the activities involved must be considered in relation to the nature and extent of the exempt function which they purport to serve. . . .

3. On page 8, lines 40 through 42, delete "In determining whether a business purpose is paramount over an exempt purpose the court stated:" and add:

Although the relevant test under the regulation applicable in this case is a comparison of the activities in question with the exempt purpose of the organization, *Iowa State* nevertheless provides a useful guide in our analysis. The court stated:

4. On page 9, insert the following as a separate paragraph before the last paragraph which begins "Measured against the guidelines . . . .":

As we pointed out above, although the regulation applicable in *Iowa State* is slightly different from the one applicable in this case, it is nevertheless useful in our analysis.[7] In *Iowa State* the relevant regulation states that a trade or business is substantially related to the exempt purpose of an organization if the ***principal purpose*** of that trade or business is to further that exempt purpose. In determining the principal purpose, the regulation requires a comparison of the nature and size of the trade or business with the nature and extent of the activities for which the organization was granted exemption. See 26 C. F. R. § 1.513-2(a)(4). In a slightly different vein, the regulation applicable to the Carle Foundation states that a trade or business is substantially related to an organization's exempt purpose if it ***contributes importantly*** to the accomplishment of that exempt purpose. In determining whether certain activities contribute importantly to the exempt pur-

pose, the regulation requires that the size and extent of the activities be considered in relation to the nature and extent of the exempt function they purport to serve. See 26 C. F. R. § 1.513-1(d)(2) and (3). To tax the non-hospital sales by the Foundation Pharmacy in this case, our ultimate conclusion need not be, as it was in *Iowa State, that* "commercial" activities were more substantial than "exempt" activities. Like the court in *Iowa State,* however, we must consider the relationship between the activities and the exempt function of the organization, so that the guidelines articulated in *Iowa State* are quite instructive.

5. Insert the following footnote at the bottom of page 9:

7. The regulation used in *Iowa State* is applicable to tax years beginning before December 13, 1967, while the regulation used in this case is applicable to tax years beginning after December 12, 1967. Compare 26 C. F. R. § 1.513-2(d) with 26 C. F. R. § 1.513-1(g).

6. On page 9, delete the first sentence of the last paragraph which begins "Measured against the guidelines . . .," so that the paragraph begins with the sentence "For sales to the Clinic . . ."

7. On page 9, delete the last sentence on the page, which begins "Although not absolutely conclusive . . ." and read

Although not absolutely conclusive these substantial profits appear to contribute importantly to a business rather than to an exempt purpose and clothe this portion of the Pharmacy's activities with the attributes of a commercial enterprise.

8. On page 10, line 5, after the sentence which ends "U. S. C. §§ 511-13.," insert the following sentence:

Our holding is consistent with regulation § 1.513-1(d)(3) which reads in pertinent part:

[W]here income is realized by an exempt organization from activities which are in part related to the performance of its exempt functions, but which are conducted on a larger

scale than is reasonably necessary for performance of such functions, the gross income attributable to that portion of the activities in excess of the needs of exempt functions constitutes gross income from the conduct of unrelated trade or business.

Except for the foregoing modifications of the opinion, the petition for rehearing is DENIED.

IN THE UNITED STATES DISTRICT COURT
For the Eastern District of Illinois

THE CARLE FOUNDATION, an Illinois not for profit corporation,
Plaintiff,
vs.
UNITED STATES OF AMERICA,
Defendant.
Civil No. 75-2-148

AMENDED FINDINGS OF FACTS, CONCLUSIONS OF LAW, AND JUDGMENT

This matter is before the Court for decision following a bench trial on September 15, 1977. The Court, having considered the stipulations, exhibits and testimony, and being fully advised in the premises, makes the following Findings of Fact and Conclusions of Law.

Findings of Fact

1. The Carle Foundation (hereinafter "plaintiff") was organized on November 6, 1946, as an Illinois not for profit corporation. Its primary purpose is to provide health care to the community it serves.

2. In 1948, plaintiff was granted an exemption from federal income tax under the provisions of the Internal Revenue Code, 26 U. S. C. § 501(c)(3).

3. For plaintiff's fiscal years ended June 30, 1971, and June 30, 1972, the United States of America ("defendant") assessed deficiencies in tax in the amount of $35,949.13 and $20,166.34 respectively, based upon defendant's determination that certain income of plaintiff is taxable as unrelated business income under 26 U. S. C. § 511. Plaintiff paid such tax plus interest on May 29, 1975, and immediately thereafter filed a claim for refund.

After six months from the filing of the claim, plaintiff instituted this action.

4. Plaintiff owns and operates the Carle Foundation Hospital ("Hospital"), of which the Carle Pharmacy ("Pharmacy") is a part. Prior to 1961, the Pharmacy was operated as a partnership and profits inured to the individual partners. In 1961 the Pharmacy was sold to plaintiff, and thereafter its earnings inured to and were used by plaintiff solely in furtherance of its exempt purposes.

5. The Carle Clinic Association ("Clinic") is an unincorporated association of physicians engaged in the private practice of medicine on a for-profit basis. The doctors are employees of the Clinic and are members of the staff, but are not employees, of the Hospital. The Clinic has never applied for nor been granted an exemption from federal income tax.

6. The Hospital medical staff, with the exception of a small courtesy staff, is composed entirely of the doctors of the Clinic. In the event a patent of a Clinic physician requires hospitalization, that patient will be hospitalized at the Hospital. In addition, a former Hospital patient who no longer requires hospital treatment may be treated at the Clinic by a Clinic physician.

7. Because of the medical relationship between the Clinic and the Hospital, and the broad range of specialties of the Clinic doctors, plaintiff's medical complex functions as a teritary care center; i.e., it has the ability to handle the more seriously ill patients.

8. Both inpatient and outpatient care is provided by plaintiff's medical complex. Inpatient care is provided in the Hospital by the physicians of the Clinic in their role as the medical staff of the Hospital. Outpatient care is provided through the operating room, the emergency room, physical therapy, respiratory therapy and the Clinic. In providing care on an inpatient and outpatient basis, the Hospital and Clinic share many facilities and functions. For example, the Clinic provides all inpatient

and outpatient services in the areas of laboratory testing, radiological services, electrocardiograms, electroencephalograms, and radioisotope services.

9. The outpatient facilities which handle the medical needs of patients requiring immediate attention are the emergency room and the acute illness department. The acute illness department is a Clinic department, located in the same area as the emergency room. The emergency room is a Hospital department. Doctors staffing the medical complex will often refer patients to the acute illness department or emergency room for immediate care. The same doctors staff both departments.

10. The Hospital and the Clinic maintain a single medical record for all patients in the medical complex. These records are kept by Hospital personnel in the Clinic area of the complex. All patents treated in the medical complex, both inpatient and outpatient, receive a Clinic number, unrer which the patient's medical records are filed.

11. The quality of health care provided at the medical complex is reviewed by several joint Hospital and Clinic committees. One of these joint committees is the Audit and Risk Control Committee, which monitors the professional performance of the physicians in both the Clinic and the Hospital. Other committees monitor the progress and care of patients, whether seen in the medical complex as inpatients or outpatients. The Hospital and Clinic also coordinate and on a joint basis engage in patient education activities to allow for a smooth transition from inpatient to outpatient treatment and vice versa. Patient education is an important factor in health care. The ability to provide patient education is enhanced by the relationship between the Hospital and the Clinic.

12. The Clinic is a hospital-based group medical practice. There are significant medical advantages to patients as a result of such an affiliation between Hospital and Clinic, including: permitting the patient to receive a full range of health care services at a single complex; allowing the medical group to

serve as the outpatient department of the Hospital; enabling the patient to receive continuity of care; and permitting closer cooperation among all members of the health care team.

13. The Clinic serves as the outpatient department of the Hospital. Many medical procedures otherwise requiring hospitalization can be accomplished on an outpatient basis as a result of the medical relationship between the Hospital and the Clinic. This medical relationship encompasses the sharing of physical facilities, equipment and services, and the identity of the medical staff of both Hospital and Clinic. It results in a continuity of patient care, including the treatment and monitoring of patients on both an inpatient and outpatient basis by the same doctors, the ability to provide patient education on a joint basis, and the maintenance of a single medical history for each patient.

14. The Pharmacy plays an important role in providing health care services to the patients of the medical complex by supplying the medication needs of both inpatients and outpatients. The Pharmacy maintains a patient profile for each patient of the complex who has received medications from the Pharmacy during the course of treatment. The profile is a listing of the drugs administered or prescribed, and encompasses drugs administered or prescribed on both an inpatient and outpatient basis. The patient profile maintained by the Pharmacy is another element of continuity of care and as such permits plaintiff to provide better health care to its patients.

15. The Pharmacy supplies the needs of the Clinic for medications administered to Hospital outpatients treated in the Clinic. In order to insure continuity of medication, it is important that the Clinic and the Hospital receive their drugs from the same source.

16. Pharmacy sales directly to the Clinic and to patients receiving prescriptions in the Clinic enhance the quality of total health care because of the resulting continuity of medica-

tion and centralization of information when Hospital treatment is required. Many patients use the Pharmacy on an outpatient basis to obtain drugs not readily available elsewhere.

17. Pharmacy personnel regularly confer with the physicians of the medical complex as to the introduction and availability of new drugs as well as the withdrawal of old drugs, and the dosage of medicine to be prescribed for both inpatients and outpatients. Commercial pharmacies generally provide no comparable service.

18. Because of the Pharmacy, certain medical procedures such as hyperalimentation and chemotherapy can be administered in plaintiff's medical complex on an outpatient instead of inpatient basis.

19. At all times, the Pharmacy has been located in the inner section of the complex and has not been directly accessible from the street. The Pharmacy does not advertise its services and it is rare for a prescription to be filled which does not originate in the complex itself. Similarly, the Pharmacy does not stock a large supply of sundries or other non-prescription items.

20. Defendant has determined that income from certain Pharmacy sales constitutes unrelated business income under 26 U. S. C. § 511. Those sales may be categorized as follows:

Description	Fiscal 1971	Fiscal 1972
Sales to Outpatients	$327,788.68	$346,689.25
Sales to Clinic	54,929.15	68,114.37
Sales to the Patients of the Americana Nursing Home ...	3,311.34	16.19
Sales of Sundries	1,669.06	1,584.59
Total	$387,698.23	$416,404.40

The alleged unrelated income from these sales amounted to $89,435.69 for fiscal year 1971, and $56,554.87 for fiscal year

1972. Defendant does not dispute that all remaining sales are substantially related to plaintiff's exempt purposes.

21. Plaintiff has not established what portion of Pharmacy sales to patients of the Americana Nursing Home were made to fill prescriptions given in the course of treatment as outpatients in plaintiff's medical complex. In the years 1971-1972, the Hospital did not own the Americana Nursing Home.

Conclusions of Law

1. The Court has jurisdiction of the subject matter of this suit and of the parties hereto.

2. Organizations otherwise exempt from federal income taxation under 26 U. S. C. § 501 are subject to tax on "unrelated business taxable income" under the provisions of 26 U. S. C. § 511.

3. Title 26, U. S. C. § 512, defines "unrelated business taxable income" as:

> the gross income derived by any organization from any unrelated trade or business . . . regularly carried on by it, less the deductions allowed by this chapter. . . .

4. "Unrelated trade or business" is defined in 26 U. S. C. § 513:

> any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501 . . . .

Section 513 also provides an exception for any trade or business "carried on, in the case of an organization described in section 501(c)(3) . . . by the organization primarily for the convenience of its members, students, patients, officers or employees . . . ."

5. There is no dispute between the parties whether the Pharmacy sales are a "trade or business" under the Internal Revenue Code. Nor, except as to sales to the public and to Americana Nursing Home patients, does plaintiff claim that the Pharmacy business is not "regularly carried on."

6. Therefore, plaintiff may prevail in this case if the disputed Pharmacy sales are either "substantially related" to plaintiff's charitable purposes, or, if not so related, "primarily for the convenience of its . . . patients . . . or employees."

The "Substantially Related" Test

7. Title 26, C. F. R. § 1.513-1(d) states that trade or business is substantially related to exempt purposes where there is a causal relationship between the business activities and the achievement of exempt purposes, and the causal relationship is a substantial one:

> the production or distribution of the goods or the performance of the services from which the gross income is derived must contribute importantly to the accomplishment of those purposes . . . Whether activities productive of gross income contribute importantly to the accomplishment of any purpose for which an organization is granted exemption depends in each case upon the facts and circumstances involved.

8. Several Revenue Rulings are also relevant to the question presented here. Three 1969 rulings held that the operation of a gift shop, a cafeteria, and a parking lot by exempt hospitals did not constitute unrelated business. The basis for the decision in each case was that the various services were substantially related to the hospital's exempt purpose of providing health care for members of the community, by aiding patient treatment and recovery. Rev. Rul. 69-267, 69-268 and 69-269, 69—1 C. B. 160.

Three 1968 rulings dealt with pharmaceutical sales by an exempt hospital and the conditions under which such sales con-

stitute unrelated business income. Rev. Rul. 68-374, 68—2 C. B. 242; Rev. Rul. 68-375, 68—2 C. B. 245; Rev. Rul. 68-376, 68—2 C. B. 246.

Rev. Rul. 68-375 held that such sales were unrelated business in a fact situation somewhat similar to, but distinguishable from, the present case. In that ruling, the hospital leased office space to medical staff who found it convenient to have their private practice close to the hospital. Their private practice was independent of their hospital duties; the hospital had no authority over the treatment received by private patients; the pharmacy was maintained for the convenience of the private patients; and the pharmacy's income derived primarily from sales to the private patients. The Court believes that the facts underlying that Revenue Ruling are sufficiently different from the facts of the present case, so that the Ruling is of little guidance in the resolution of the legal issues herein.

9. Other than the statutory provisions, regulations, and rulings referred to above, there is an apparent lack of authority in this area, particularly interpreting those provisions. Therefore, the Court must apply the statutes and regulations to the facts of this case and make a determination whether the various pharmaceutical sales described in the Findings of Fact are "substantially related" to plaintiff's exempt purposes. In this regard, the Court considers the close co-operative relationship between plaintiff's Hospital and the Clinic to be of major importance to plaintiff's purpose of providing health care to its patients.

10. Of the four categories of pharmaceutical sales set forth in paragraph 20 of the Findings of Fact herein, the Court concludes that only two—prescription sales to Clinic outpatients and wholesale drug sales to the Clinic—are "substantially related" to plaintiff's exempt purposes. In light of plaintiff's purpose of providing health care to its patients and the large number of Hospital patients who are also Clinic patients and vice versa, as well as the relationship between the Hospital and Clinic,

including shared staff, unified record-keeping, and joint review of treatment and care, it is the opinion of this Court that Pharmacy sales in the two categories above "contribute importantly to the accomplishment" of plaintiff's exempt purposes. Pharmacy sales in the other two categories do not so contribute.

11. Therefore, plaintiff's income from prescription sales to Clinic outpatients and wholesale drug sales to the Clinic are not subject to tax as unrelated business income.

The "Primarily for the Convenience of Its Patients or Employes" Test

12. Any of the categories of Pharmacy sales, whether or not they have been determined to be substantially related to plaintiff's exempt purposes, would not constitute unrelated business taxable income if they are carried out primarily for the convenience of plaintiff's patients or employees. 26 U. S. C. § 513(a)(2).

13. The Court concludes that prescription sales to Clinic outpatients and wholesale drug sales to the Clinic, even if not deemed substantially related to plaintiff's exempt purposes, have been amply demonstrated to be carried out primarily for the convenience of plaintiff's patients, and not primarily for any other reason.

14. The other two categories of sales do not meet either of the two tests set forth above and therefore constitute unrelated business taxable income. These categories are: prescription sales to residents of Americana Nursing Home, and sundry sales at retail. Plaintiff failed to show the relationship of these sales to either its exempt purposes or the convenience of its patients or employees.

"Regularly Carried On"

15. Plaintiff has failed to show that sales to residents of Americana Nursing Home and sales to the public were not "regularly carried on" within the meaning of 26 U. S. C. § 512,

and has therefore failed to meet its burden with regard to whether these sales constitute unrelated business taxable income.

16. The Court has been advised that defendant has agreed that plaintiff is to be allowed a greater deduction for expenses than previously determined.

Judgment

It Is Therefore Ordered, Adjudged and Decreed that plaintiff's claim for refund be, and the same is hereby, allowed with respect to the following categories of Pharmacy sales:

A. Prescription sales to Clinic outpatients.

B. Wholesale drug sales to the Clinic.

It Is Further Ordered that plaintiff's claim for refund be, and the same is hereby, denied with respect to all other disputed items.

It Is Further Ordered that with respect to the disputed items for which plaintiff's claim has been denied, defendant shall make a partial refund based on the greater deduction allowed for expenses.

It Is Further Ordered that defendant shall compute the amount of the total refund due plaintiff, together with interest, and prepare the appropriate Judgment, each part to bear its own costs.

Entered this 29th day of June, 1978, nunc pro tunc as of March 30, 1978.

/s/ (Illegible)

Chief Judge